Updated Informative Digest for the State Board of Equalization's

Re-Adoption of California Code of Regulations,

Title 18, Section 474, *Petroleum Refining Properties*

The State Board of Equalization (Board) held a public hearing regarding the proposed re-adoption of California Code of Regulations, title 18, section (Rule) 474, *Petroleum Refining Properties*, on December 18, 2014. At the conclusion of the public hearing, the Board voted to re-adopt Rule 474 without making any changes.

The Board received a letter dated December 9, 2014, from Mr. Jeffrey Prang, Los Angeles County Assessor, in support of the Board's re-adoption of Rule 474 and the Board's assessment of the economic impact of re-adopting Rule 474. The Board received a letter dated December 15, 2014, from Mr. David Twa, County Administrator for Contra Costa County, in support of the Board's re-adoption of Rule 474. The Board received a letter dated December 16, 2014, from Mr. Gus Kramer, Contra Costa County Assessor, in support of the Board's re-adoption of Rule 474. The Board received a letter dated December 16, 2014, from Mr. Donald Flessner, Executive Vice-President of Baker & O'Brien, Inc., in support of the Board's re-adoption of Rule 474. Mr. Albert Ramseyer, Deputy County Counsel for Los Angeles County, appeared at the public hearing on December 18, 2014, on behalf of Mr. Prang and provided testimony in support of the Board's re-adoption of Rule 474. Ms. Rebecca Hooley, Deputy County Counsel for Contra Costa County, appeared at the public hearing on December 18, 2014, and provided testimony in support of the Board's re-adoption of Rule 474. Mr. Peter Yu, Principal Appraiser of the Business Division for the Contra Costa County Assessor's Office, appeared at the public hearing on December 18, 2014, and provided testimony in support of the Board's assessment of the economic impact of re-adopting Rule 474. And, Mr. Flessner also appeared at the public hearing on December 18, 2014, and provided testimony in support of the Board's re-adoption of Rule 474. Their public comments in support of the Board's re-adoption of Rule 474 are quoted in the final statement of reasons.

Also, the Board's response to Mr. Twa's and Ms. Hooley's recommendations that the Board re-adopt Rule 474 to reduce potential litigation and a discussion of Mr. Flessner's and Mr. Kramer's comments regarding the application of the rebuttable presumption in Rule 474 are included in the final statement of reasons. And, the Board's response to Mr. Twa's and Ms. Hooley's recommendations discusses the application of Revenue and Taxation Code (RTC) sections 538 and 5152, which were not discussed in the informative digest included in the Board's notice proposing the re-adoption of Rule 474 because neither RTC section directly relates to the proposed re-adoption of Rule 474.

The Board received an email on October 24, 2014, from Ms. Michelle Schumacher, which indicated that Ms. Schumacher opposes the re-adoption of Rule 474 because she believes it provides "preferential treatment" to the oil industry. The Board received a letter dated December 17, 2014, from Ms. Gina Rodriquez, Vice President of State Tax Policy for the California Taxpayers Association (CalTax), which requested that the Board

reject the re-adoption of Rule 474 and alleged that the Board failed to comply with the Administrative Procedure Act (ch. 3.5 of pt. 1 of div. 3 of tit. 2 (commencing with § 11340) of the Gov. Code) (APA) in assessing the economic impact of the re-adoption of Rule 474. The Board received a letter dated December 17, 2014, from Ms. Catherine H. Reheis-Boyd, President of the Western States Petroleum Association (WSPA), which opposed the Board's re-adoption of Rule 474 and alleged that the Board failed to comply with the APA and the California Supreme Court's mandates in *Western States Petroleum Association v. Board of Equalization* (2013) 57 Cal.4th 401 (hereafter *WSPA v. BOE*) in assessing the economic impact of re-adopting Rule 474. Mr. Craig A. Becker, an attorney for Pillsbury Winthrop Shaw Pittman, LLP, appeared at the public hearing on December 18, 2014, and provided testimony opposing the Board's re-adoption of Rule 474 on behalf of WSPA. Also, Mr. Walt Turville, Senior Property Tax Representative for Chevron, appeared at the public hearing on December 18, 2014, and provided testimony opposing the Board's re-adoption of Rule 474.

Most of the comments opposing the Board's re-adoption of Rule 474 are quoted in their entirety in the final statement of reasons. However, some of the comments opposing the Board's re-adoption of Rule 474, particularly some of the comments in the 15-page letter from Ms. Reheis-Boyd, are summarized or partially quoted in the final statement of reasons. Also, all of the comments opposing the Board's re-adoption of Rule 474 are responded to in the final statement of reasons, and the responses to Ms. Reheis-Boyd letter and Mr. Becker's testimony discuss the application of RTC section 402.5, Rule 2, *The Value Concept*, Rule 6, *The Reproduction and Replacement Cost Approaches to Value*, and Rule 8, *The Income Approach to Value*, which were not discussed in the informative digest included in the notice proposing the re-adoption of Rule 474 because neither the RTC section nor the rules directly relate to the proposed re-adoption of Rule 474.

There have not been any changes to the applicable laws or the effect of, the objective of, and anticipated benefit from the proposed re-adoption of Rule 474 that were not described in the informative digest included in the notice of proposed regulatory action. The informative digest included in the notice of proposed regulatory action provides:

> Summary of Existing Laws and Regulations
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> *Initial Adoption of Rule 474*
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> The Board previously adopted Rule 474. In *WSPA v. BOE*, the California Supreme Court provided the following summary of the applicable property tax laws as they existed prior to the Board's initial adoption of Rule 474 and the effect of the initial adoption of Rule 474:
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> > Article XIII, section 1 of the California Constitution declares that "[a]ll property is taxable and shall be assessed at the same percentage of fair market value." (Cal. Const., art. XIII, § 1, subd. (a).) Proposition 13, an initiative measure enacted in June 1978,

added article XIII A to the California Constitution and changed the taxation of real property by replacing "the fair market valuation standard with that of acquisition value." (*Roy E. Hanson, Jr. Mfg. v. County of Los Angeles* (1980) 27 Cal.3d 870, 873 [167 Cal. Rptr. 828, 616 P.2d 810].) Article XIII A, section 2 provides that all real property, except for property acquired prior to 1975, shall be assessed and taxed at its value on the date of acquisition, subject to a 2 percent maximum annual inflationary increase. (*Amador Valley Joint Union High Sch. Dist. v. State Bd. of Equalization* (1978) 22 Cal.3d 208, 235 [149 Cal. Rptr. 239, 583 P.2d 1281].) This is sometimes referred to as the indexed or adjusted base year value. (See Bd. of Equalization, Assessors' Handbook, Section 501, Basic Appraisal (2002 rev.) appen. A, Assessment Pre- and Post-Proposition 13, p. 137.)

Proposition 13 did not address how real property should be assessed and taxed when its market value declines instead of appreciates. To address this issue, California voters passed Proposition 8 in November 1978. Proposition 8 amended article XIII A so that it now reads: "The full cash value base may reflect from year to year the inflationary rate not to exceed 2 percent for any given year or reduction as shown in the consumer price index or comparable data for the area under taxing jurisdiction, or may be reduced to reflect substantial damage, destruction, or other factors causing a decline in value." (Cal. Const., art. XIII A, § 2, subd. (b).) In other words, when the value of real property declines to a level below its adjusted base year value under Proposition 13, the value of the property is determined according to its actual fair market value.

The Legislature formed a task force to study the implementation of the new real property tax system mandated by Proposition 13 and Proposition 8. In January 1979, the task force submitted a report and recommendations to the Assembly Committee on Revenue and Taxation, officially titled Report of the Task Force on Property Tax Administration (hereafter Task Force Report). (See *Pacific Southwest Realty Co. v. County of Los Angeles* (1991) 1 Cal.4th 155, 161 [2 Cal. Rptr. 2d 536, 820 P.2d 1046].) The Task Force Report has been recognized as a statement of legislative intent for purposes of interpreting the statutes enacted to implement Proposition 13 and Proposition 8. (See, e.g., *Auerbach v. Assessment Appeals Bd. No. 1* (2006) 39 Cal.4th 153, 161 [45 Cal. Rptr. 3d 774, 137 P.3d 951].)

The report recommended that "the assessed value of real property be the lesser of the Prop. 13 base value compounded annually by

2% or full cash value. These changes will be measured by that appraisal unit which is commonly bought and sold in the market, or which is normally valued separately." (Task Force Rep., *supra*, at p. 29.) Revenue and Taxation Code section 51 was subsequently amended to incorporate the task force recommendations. (All further statutory references are to the Revenue and Taxation Code unless otherwise specified.) Section 51, subdivision (a) (hereafter section 51(a)) provides that "the taxable value of real property shall . . . be the lesser of: [¶] (1) Its base year value, compounded annually since the base year by an inflation factor . . ." not to exceed 2 percent per year, or "(2) Its full cash value, as defined in Section 110, as of the lien date, taking into account reductions in value due to damage, destruction, depreciation, obsolescence, removal of property, or other factors causing a decline in value." Section 110, subdivision (a) defines the term "full cash value," synonymously with the term "fair market value," as "the amount of cash or its equivalent that property would bring if exposed for sale in the open market under conditions in which neither buyer nor seller could take advantage of the exigencies of the other, and both the buyer and the seller have knowledge of all of the uses and purposes to which the property is adapted and for which it is capable of being used, and of the enforceable restrictions upon those uses and purposes."

Most significantly for this case, the term "real property" under section 51, subdivision (d) (hereafter section 51(d)) is defined as "that appraisal unit that persons in the marketplace commonly buy and sell as a unit, or that is normally valued separately." This definition echoes almost verbatim the definition recommended by the Task Force Report. The statute does not further define "appraisal unit," but the term is defined by regulation as "a collection of assets that functions together, and that persons in the marketplace commonly buy and sell as a single unit or that is normally valued in the marketplace separately from other property . . . ." (Cal. Code Regs., tit. 18, § 324.)

In the wake of Proposition 13 and Proposition 8, and shortly before the enactment of section 51, the Board promulgated and then amended rule 461, a regulation applicable to most real property used for manufacturing. (Cal. Code Regs., tit. 18, § 461 (Rule 461).) Rule 461, subdivision (e) (hereafter Rule 461(e)) provides: "Declines in value will be determined by comparing the current lien date full value of the appraisal unit to the indexed base year full value of the same unit for the current lien date. Land and improvements constitute an appraisal unit except when measuring declines in value caused by disaster, in which case land shall

constitute a separate unit. For purposes of this subdivision, fixtures and other machinery and equipment classified as improvements constitute a separate appraisal unit."

At the same time that it adopted Rule 461(e)'s classification of fixtures as "a separate appraisal unit," the Board adopted two exceptions to this rule for certain types of industrial property where land and fixtures were valued as a single unit in the marketplace: Rule 468, which applies to oil and gas properties, and Rule 469, which applies to mining properties. (See Cal. Code Regs., tit. 18, §§ 468, subd. (c)(6) (Rule 468), 469, subd. (e)(2)(C) (Rule 469).) Rule 473, adopted in 1995, similarly treats land and fixtures on geothermal properties as a single appraisal unit. (Cal. Code Regs., tit. 18, § 473(e)(4)(C) (Rule 473).) Petroleum refinery property was covered by Rule 461(e) until the Board's adoption of Rule 474.

In September 2006, the Board voted three to two to adopt Rule 474 to address "the valuation of the real property, personal property, and fixtures used for the refining of petroleum." (Rule 474, subd. (a).) Subdivision (b)(1) of Rule 474 states that "[t]he unique nature of property used for the refining of petroleum requires the application of specialized appraisal techniques designed to satisfy the requirements of article XIII, section 1, and article XIII A, section 2, of the California Constitution. To this end, petroleum refineries and other real and personal property associated therewith shall be valued pursuant to the principles and procedures set forth in this section." Rule 474, subdivision (c)(2) states that "'[a]ppraisal unit' consists of the real and personal property that persons in the marketplace commonly buy and sell as a unit." Most pertinent here, subdivision (d) states that "[f]or the purposes of this section: [¶] (1) Declines in value of petroleum refining properties will be determined by comparing the current lien date full value of the appraisal unit [(i.e., its value in an open market transaction)] to the indexed base year full value of the same unit [(i.e., its Proposition 13 value)]. [¶] (2) *The land, improvements, and fixtures and other machinery and equipment classified as improvements for a petroleum refining property are rebuttably presumed to constitute a single appraisal unit* . . . . [¶] (3) In rebutting this presumption, the assessor may consider evidence that: [¶] (A) The land and improvements including fixtures and other machinery and equipment classified as improvements are not under common ownership or control and do not typically transfer in the marketplace as one economic unit; or, [¶] (B) When the fixtures and other machinery and equipment classified as improvements are not functionally and physically integrated with

> the realty and do not operate together as one economic unit." (Rule 474, subd. (d); italics added [in original opinion].)
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> [¶] . . . [¶]
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> In November 2007, the Office of Administrative Law approved the regulation, and it became effective in December 2007. (*WSPA v. BOE*, pp. 409-413.)

History Regarding WSPA v. BOE

In *WSPA v. BOE*, the California Supreme Court also explained that in December 2008, the Western States Petroleum Association (WSPA) filed a complaint challenging the validity of Rule 474 and seeking a declaration that the Board violated the Administrative Procedure Act (APA) (Gov. Code, § 11340 et seq.) in adopting the rule. (WSPA v. BOE, pp. 413-414.) And, "[i]n October 2009, the Board and WSPA filed cross-motions for summary judgment. WSPA argued that Rule 474 violates section 51(d) and California Constitution, article XIII A, and that the Board failed to provide an adequate statement of economic impact as required by the APA. The trial court granted WSPA's summary judgment motion on both grounds, and the Court of Appeal affirmed on both grounds" before the California Supreme Court granted review. (*WSPA v. BOE*, p. 414.)

As explained in more detail in the initial statement of reasons, the California Supreme Court disagreed with all of WSPA's arguments as to why Rule 474 violates RTC section 51, subdivision (d) (hereafter section 51(d)), and California Constitution, article XIII A. The Court specifically concluded that "Rule 474's market-based approach to determining the proper appraisal unit for petroleum refinery property ensures that reductions in property values are measured according to fair market value. Thus, Rule 474 appears consistent with articles XIII and XIII A." (*WSPA v. BOE*, pp. 416-417.) Furthermore, the California Supreme Court specifically concluded that "Rule 474 is also consistent with section 51(d)." (*WSPA v. BOE*, p. 417.) The Court said that "[b]y its terms, the statute provides two alternative methods of determining the appraisal unit that constitutes taxable real property: it is either (1) a unit 'that persons in the marketplace commonly buy and sell as a unit' or (2) a unit 'that is normally valued separately.' Rule 474 applies the first method to petroleum refinery property." (*WSPA v. BOE*, p. 417.)

Although the California Supreme Court held that Rule 474 was substantively valid in *WSPA v. BOE*, the Court still concluded that the Board's adoption of Rule 474 was procedurally invalid under the APA. (*WSPA v. BOE*, pp. 408-409.) The Court held that the Board did not properly assess the economic impact of Rule 474 and that the Board's

initial determination that Rule 474 would not have a significant adverse economic impact on businesses did not substantially comply with the APA (Gov. Code, §§ 11346.2, subd. (b)(5)(A), 11346.3, 11346.5, subd. (a)(8)) because:

- "The Board relied on a 2006 document titled 'Revenue Estimate' concerning proposed Rule 474. According to the document, which was prepared by Board staff, WSPA reported that there are 20 major refineries located in California, with five in Los Angeles County and four in Contra Costa County. (Bd. of Equalization, Revenue Estimate, Issue No. 6-001 (June 7, 2006) p. 2.) County data indicated that the total assessment in these two counties was over $ 14 billion, with about 80 percent of that value enrolled as fixtures. Projecting figures statewide, the Board staff estimated that there was $ 32 billion of refinery property, of which $ 25 billion consisted of fixtures and $ 7 billion in land and nonfixture improvements. To 'conservatively estimate' the incremental amount of taxable assessed value resulting from the proposed rule, the Board staff multiplied the $ 7 billion in land value by a 2 percent appreciation factor to conclude that Rule 474 would yield 'at least $ 140 million' in additional assessed value. (Revenue Estimate, at p. 3.) The Board staff then multiplied $ 140 million by the 1 percent tax on real property permitted under article XIII A to arrive at $ 1.4 million as the annual estimated revenue effect of Rule 474, while acknowledging that '[t]he actual revenue effect could be considerably higher or lower depending on the number of properties [affected] and the actual amount of offsetting values.' (Revenue Estimate, at p. 3.) Based on these calculations, the Board concluded that Rule 474 'will not have a significant adverse economic impact on businesses.'" (*WSPA v. BOE*, pp. 429-430.);
- The Court concluded that "[e]ven assuming the Board could reasonably project $ 32 billion as the total value of 20 refineries statewide based on data showing $ 14 billion as the total value of nine refineries in two counties, the Board's analysis offers no explanation why multiplying $ 7 billion in land value by a 2 percent appreciation factor is, empirically or conceptually, a valid or reasonable way to estimate the amount of fixture depreciation that would be offset by appraising land and fixtures as a single unit." (*WSPA v. BOE*, p. 430.); and
- "[T]he Board's calculation failed to consider prior land appreciation and the full tax impact that would occur if land were valued at actual market value rather than adjusted base year value." (*Ibid*.)

<u>Effect, Objective, and Benefit of the Proposed Re-Adoption of Rule 474</u>

During the Board's September 10, 2013, meeting, the Board considered a Chief Counsel Memorandum dated August 28, 2013. In the Chief Counsel Memorandum, Board staff explained that the Board adopted Rule 474 on September 27, 2006, to clarify that, consistent with California Constitution article XIII, section 1, article XIII A (which contains Proposition 13 as amended by Proposition 8), RTC section 51, and Rules 461, *Real Property Value Changes*, and 324, *Decision*, refinery property consisting of land, improvements, and fixtures is rebuttably presumed to be a single appraisal unit in determining Proposition 8 declines in value below the Proposition 13 adjusted base year value for property tax valuation purposes. In the Chief Counsel Memorandum, Board staff also explained that the California Supreme Court held that Rule 474 was substantively valid in *WSPA v. BOE*. However, nevertheless, the Court also invalidated Rule 474 on procedural grounds, finding that the Board failed to provide an adequate assessment of the rule's economic impact during the rulemaking process as required by the APA. In particular, the Supreme Court held that Rule 474 is procedurally deficient because the Board did not make a reasoned estimate of all the cost impacts of the rule on affected parties. Therefore, in the memorandum, Board staff requested the Board's authorization to repeal Rule 474 pursuant to California Code of Regulations, title 1, section 100 (Rule 100). Board staff also requested the Board's authorization to initiate the rulemaking process to re-adopt Rule 474 following the APA's regular notice and public hearing process after Board staff reassessed the economic impact of Rule 474 on affected businesses in accordance with the APA and *WSPA v. BOE*.

Therefore, at the conclusion of the Board's discussion of the Chief Counsel Memorandum dated August 28, 2013, during its meeting on September 10, 2013, the Board Members unanimously voted to authorize staff to repeal Rule 474 pursuant to Rule 100, and initiate the rulemaking process to re-adopt Rule 474 after Board staff reassessed the economic impact of Rule 474 in accordance with the APA and *WSPA v. BOE*. The Board determined that it is reasonably necessary to re-adopt Rule 474 to have the effect and accomplish the objective of clarifying that petroleum refinery land, improvements, and fixtures are rebuttably presumed to constitute a single appraisal unit for determining declines in value because petroleum refineries are commonly bought and sold as a unit in the marketplace. The Board anticipates that the re-adoption of Rule 474 will clarify the treatment of petroleum refinery property for purposes of measuring declines in value, and thereby benefit county assessors and the owners of petroleum refineries by promoting fairness and uniformity in the assessment of petroleum refinery property throughout the state.

The Board subsequently repealed Rule 474 pursuant to Rule 100, effective October 30, 2013. However, regardless of the repeal of Rule 474, county assessors are still authorized to determine that refinery property (land,

improvements, and fixtures) constitutes a single appraisal unit for measuring declines in value when persons in the marketplace commonly buy and sell refinery property as a unit, in accordance with RTC section 51(d) as interpreted by the California Supreme Court in *WSPA v. BOE* (discussed above).

In addition, Board staff has reassessed the economic impact of Rule 474 in accordance with the APA and *WSPA v. BOE*. Staff's economic impact assessment is included in the initial statement of reasons, and the results of staff's assessment are provided below.

The Board has performed an evaluation of whether Rule 474 is inconsistent or incompatible with existing state regulations and determined that the proposed rule is not inconsistent or incompatible with existing state regulations. This is because proposed Rule 474 is the only state regulation that specifically prescribes the appraisal unit for determining declines in value of petroleum refining properties. The Board has also determined that there are no comparable federal regulations or statutes to proposed Rule 474.